Backgrounder

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THE IDEA OF CANADA-U.S. FREE TRADE

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THE IDEA OF CANADA-U.S. FREE TRADE

INTRODUCTION

The idea of a Canada-U.S. free trade arrangement predates Confederation. A limited form of free trade actually existed between the countries during the 1850s and 1860s although it did not include manufactured goods. As well, an agreement to establish free trade was reached in 1911 and was accepted by the U.S. Congress. It was rejected by Canada, however, following a general election in which a Liberal government which supported the treaty was defeated by a Conservative government which had campaigned against such an arrangement. Only once since 1911 has there been any serious discussion of the idea. During 1947 and 1948, secret high level negotiations actually led to the drafting of a tentative agreement, but the Liberal government changed its mind and the treaty was never signed or the discussions made public.

Since 1867, the two major political parties have been both for and against the idea of a free trade arrangement. The difference between the two parties, as one writer noted, was that "the Liberals do not want the tariff to go any higher and the Conservatives do not want it to go any lower."(1) As appealing as the economic arguments can be, a party's position on free trade with the U.S. can win, or lose, elections. It was the major issue in at least three general elections before 1911, and has been raised as a minor issue in most others.

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(1) L.D. Wilgress, Canada's Approach to Trade Negotiations, The Private Planning Association of Canada, 1963, p. 1.

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THE RECIPROCAL FREE TRADE AGREEMENT OF 1854-66

The Reciprocity Treaty of 1854(2) provided for free trade between the United States and the British North American colonies of many natural products including timber, grain, fish, animals, meat, butter, cheese, flour and coal; manufactured goods were not included. The treaty was the result of Britain's adoption of the policy of free trade in 1846 and her insistence that her colonies adopt it also. In fact, the treaty was negotiated and administered by the British for the colonies. It was not an attempt to establish closer economic integration between the two countries but rather an attempt to facilitate the existing trading patterns.

The treaty became the subject of increasing complaints from the U.S. Congress and the U.S. unilaterally abrogated it in 1866, citing as the main reason the increased Canadian tariffs on manufactured goods brought about by the Cayley-Galt tariffs of 1858-59. However, as the treaty was never intended to include manufactured goods, it was felt that the U.S. actions were rather the result of U.S. dissatisfaction with the British stance on the Civil War, combined with the lobbying of the U.S. Congress by manufacturers seeking increased protection. This is perhaps the first illustration of the susceptibility of the U.S. Congress and Senate to special interest lobbying that would make treaty-making difficult between the two countries.

The Reciprocity Treaty of 1854 was widely supported by politicians of both major parties, which showed no substantial differences on this issue. There were several initiatives from Canadians to renew reciprocity between the two countries, to which the U.S. did not respond, as it was pursuing protectionist trade policies.

Attempts to renegotiate a reciprocal arrangement with the U.S. apparently achieved success in 1874. The draft treaty included, in addition to the natural products outlined in the 1854 treaty, a wide range of manufactured products such as agricultural implements, steel, paper,

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(2) This discussion is drawn from O.J. McDiarmid, Commercial Policy in the Canadian Economy, Harvard University Press, Cambridge (Mass.), 1946.

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locomotives, furniture, boots and shoes, wood manufactures and other manufactured goods. The treaty was approved by the British government and required only the assent of the U.S. Senate to become effective. However, this approval was never obtained. In effect, all Canadian attempts at reciprocity were refused because the U.S. was in a protectionist period and would not consider freer trade with Canada. The failure of this treaty to be ratified is notable for several reasons. First, the willingness of the Canadian government to consider free trade in such a broad range of manufactured goods has never been repeated. Second, the U.S. rejection of the treaty fractured the consensus on the benefits of free trade with the U.S. that had existed among most Canadian politicians. Third, the inability of the Canadians to interest the Americans in free trade led Canadian politicians to concentrate on building up the Canadian manufacturing sector through protectionist policies, culminating in the National Policy of 1879.

THE NATIONAL POLICY OF 1879

The general election of 1878 was fought on the issue of protection for Canadian manufacturers; the Conservatives campaigned on a promise to raise tariffs and to protect jobs as part of Macdonald's National Policy (other major elements of which were the completion of a railway to the Pacific and the settlement of the Prairies).(3) The Liberal Party, led by Alexander MacKenzie, campaigned on a promise of unrestricted reciprocity with the U.S. and against an increase in tariffs. The victory by the Conservatives was in part a response to U.S. rejection of reciprocity in 1874 and Macdonald's skillful appeal to nationalism and patriotism. However, it should be noted that the National Policy did contain a never-used provision on reciprocity for natural products should a treaty be negotiated between the two countries.

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(3) Until 1879, tariffs served mainly as a major source of government revenue. Macdonald shifted the emphasis to protection as he tried to encourage the diversification and expansion of Canadian manufacturing.

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A difference in attitude between the two parties emerged after the election of 1878. The Conservatives, having campaigned on the benefits that higher tariffs and greater protection would bring, began to implement a commercial policy which still finds support in both parties and the Canadian public, namely, the use of tariffs to protect Canadian industry. The Liberals, on the other hand, though not unanimously, clung to a policy of "unrestricted reciprocity," which Sir Wilfrid Laurier firmly supported, and of which the essence was freer trade with the U.S. As well, the Liberals were against raising tariff levels.

This division between the two parties was visible again in the general elections of 1891 and 1911. In 1891, the Liberals put forth their policy of "unrestricted reciprocity" with the U.S., only to be soundly defeated by the Conservatives, who portrayed themselves as in favour of Canadian nationalism, political independence and the connection with the Empire as shown by the National Policy.

The Liberals, under Laurier, came to office in 1896; reciprocity was not a major issue in the campaign. Although the Liberals had been loud critics of high tariffs and extollers of free trade, they did not tear down any of the protective barriers erected by the Conservatives. In fact, the scope of the National Policy was extended. The Laurier government negotiated a trade reciprocity agreement with the U.S., but to its chagrin, found that its support of reciprocity resulted in another election defeat. The election of 1911 resembled the election of 1891. The Conservatives campaigned against reciprocity with the U.S. while the Liberals campaigned for it. One difference between the two elections was that by 1911 a tentative agreement had already been negotiated. This treaty had been at the initiative of the U.S. government and resembled the treaty of 1854 but included some manufactured goods. The Liberals felt the treaty was so favourable to Canada that they did not expect it to be a major issue in the campaign. "In fact it became the principal issue of the election of 1911 and, while a number of other factors no doubt played a part, the defeat of the government was a defeat for reciprocity."(4)

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(4) Ibid., p. 237.

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The idea of reciprocity with the U.S. has not decided any elections since 1911 although it has been raised at a minor level in most. Although reciprocity had led to the defeat of two Liberal governments, the party did not completely relinquish the idea. Upon their return to power in 1921, the Liberals (under King) were able to state "as to the willingness of Canada to have a measure of reciprocity between the two countries, there ought to be no question... They (the U.S.) know our willingness in this regard, and I think it is well we should try again."(5) As well, the Liberal Minister of France, Fielding, referred to the idea favourably in the Budget debate in both 1922 and 1923. The Conservatives, on the other hand, were still believers in Macdonald's National Policy and were against freer trade with the U.S. They were also convinced that trade should be increased within the British Empire.

Throughout the early 1930s, commercial relations between Canada and the U.S. reached a low point as a result of depressed economic conditions, the commercial policy of the U.S. (higher tariffs and more protection) and Canadian reactions to it (retaliatory tariffs). The election of a new American administration, followed by the passage of the Trade Agreements Act of 1934, cleared the way for reciprocal reductions. The two agreements of 1935 and 1938 were the first large-scale commercial agreements between Canada and the U.S. concluded since the Reciprocity Treaty of 1854 and are significant for that reason. However, the treaties did not break new ground as much as they returned relations to their level of the 1920s (in particular, they reduced some of the stronger protectionist aspects of the U.S. Hawley-Smoot Tariff of 1930).

THE NEGOTIATIONS OF 1947-48

Canadian-U.S. trade negotiations changed significantly after the Second World War, their pattern shifting from essentially bilateral (although the United Kingdom had always been considered by Canadian

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(5) Ibid., p. 274. Efforts were made at the Ministerial level to interest the U.S. in such an arrangement but nothing came of them as the U.S. was pursuing protectionist policies.

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negotiators) to multilateral and conducted under the auspices of the General Agreement on Tariffs and Trade (the GATT). However, despite the multinational negotiating, Canada and the U.S. were most interested in the bilateral discussions.(6) Important reductions in tariffs and access to each other's markets have been made within the GATT.

The nearest Canada came to a free trade treaty in the post-World War II era was in 1947. The close integration of the two economies during the Second World War led officials on both sides of the border to consider a plan that would remove tariffs on many products. The Canadian economy was going through an exchange rate crisis arising primarily from the inability of the United Kingdom and the European countries to pay for their imports from Canada. The U.S., on the other hand, was apparently willing to help Canada through this crisis and agreed to reduce the tariff walls between the two countries.

The talks between Canada and the U.S. were carried on in secret, with only a small number of officials from both sides, during 1947 and 1948. One of the top Canadian officials was Lester Pearson, then Under Secretary of State for External Affairs. MacKenzie King must have seen some merit in the discussions, as he allowed them to proceed to the point where a tentative agreement was produced in March 1948. However, the agreement was never put into effect for reasons that are still not completely understood. According to one source, "As time went by, however, it became clear that U.S. approval would be protracted, complex and uncertain. The Prime Minister's early enthusiasm and strong support gave way to doubts that were reinforced by his advancing age, impending retirement, worry about burdening his successor with so large a task at the outset of his tenure, and by the impending U.S. election."(7) However, according to another source, the reason was that "King had had one of his mystical experiences, guidance from Beyond, as he called it. A 1905 book

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(6) The term "reciprocity" had by this time been removed from the politicians' vocabulary and has only recently reappeared, although with a slightly different meaning.

(7) Simon S. Reisman, "The Issue of Free Trade," in Edward R. Fried and Philip H. Trezise, ed., U.S.-Canadian Economic Relations: Next Steps?, The Brookings Institution, Washington, 1984.

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he just happened to pick off a shelf convinced him that the free trade scheme was bad for Canada"(8) (this he confided to his diary). In any case, there would have probably been strong opposition from the Conservative Party, which was against any closer integration with the U.S. economy. MacKenzie King probably was afraid that the experience of 1911, in which Laurier and the Liberals had lost the election on the issue of reciprocity, was going to recur, with the Liberals losing once again.

The almost-agreement in 1947-48 was the last, and perhaps best, opportunity for free trade between the two countries. The negotiated agreement met practically all of the Canadian concerns about transitional safeguards; it was negotiated during a balance-of-payments crisis for Canada; the U.S. had taken the initiative; and the treaty could be carried out within the framework of the GATT so as to minimize the effect on other trading partners. However, the actions of MacKenzie King, generally considered to have had very astute political instinct, suggest that such a treaty might not have been politically acceptable and might have caused the Liberals to lose an election. King went as far as to say that should the North American free trade plan be revived after his retirement, he would return and oppose his own party on this issue.(9)

THE POST-WAR YEARS: 1948-1967

After the negotiations of 1947-48 to negotiate a free trade arrangement between Canada and the U.S., the establishment of the General Agreement on Tariffs and Trade (the GATT) in 1948 changed the focus of trade negotiations. Canada used the various multinational tariff negotiations conducted under GATT auspices to reduce U.S. tariffs and seek better access to the U.S. market. The idea of free trade was supported by several prestigious organizations (such as the Economic Council of Canada

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(8) E. Mahant and G. Mount, An Introduction to Canada-U.S. Relations, Methuen, Toronto, 1984, p. 22.

(9) Ibid., p. 182.

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and the C.D. Howe Institute) as well as a Senate Committee, but not by any elected politician.(10)

As well, the post-World War II period saw an increasing concern with the size and nature of Canada's commercial ties with the U.S. Elected governments generally tried to reduce Canada's dependence on the other country and none preached the benefits of a free trade arrangement with the U.S. One exception to this trend was the freeing of trade in agricultural equipment between the two countries in 1949. This trade, however, was relatively minor and its freeing did not have any major effects.

The Conservatives and Liberals both believed in and pursued the multilateral approach to trade policy. Between 1948 and 1965,(11) tariffs were greatly reduced between Canada and the U.S. within the four rounds of multinational tariff negotiations conducted by the GATT: Annecy, France (1949); Torquay, England (1951); and Geneva (1956 and 1960-62).

However, trade with the U.S. was never absent from election campaigns. The Conservatives under John Diefenbaker, were primarily concerned with reducing Canada's dependence on the U.S. During the campaign of 1957, Diefenbaker stressed the need for greater trade with the U.K. and the Commonwealth. He announced his intention to divert 15% of Canada's trade from the U.S. to the United Kingdom. Despite this intention, the Conservatives had no workable plans for how this could be carried out. One suggestion was the possibility of a free trade arrangement with Great Britain, but this was not practical given the level and nature of Canada's trade with the U.S. and the formation of the European Economic Community which, although the U.K. did not join at the beginning, was the natural direction for that country's trade.

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(10) In this regard, see comments by Mitchell Sharp, in "Canada's Independence and U.S. Domination," Canada-U.S. Economic Relations, p. 17.

(11) The discussion in this section is drawn from various issues of the Canadian Annual Review of Politics and Public Affairs, by University of Toronto Press, and Canada in World Affairs, Oxford University Press, Toronto.

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As the EEC became a reality in 1958, Lester Pearson, in opposition, suggested that an Atlantic free trade area, involving Canada, the U.S. and the U.K., might be possible. However, nothing came of this proposal.

Despite Diefenbaker's intention to reduce Canada's dependence on the U.S. economy, his government did manage to negotiate several agreements with respect to defence production-sharing between Canada and the U.S. The U.S. agreed, in 1958, to exempt Canadian suppliers from the provisions of the Buy American Act and the U.S. tariffs on defence products. However, these agreements have had a limited effect as Canadian manufacturers generally receive benefits when the Canadian government receives "offsets" on purchasing U.S. equipment. The Pearson government continued these defence production-sharing policies when it came to office in 1963.

During the Diefenbaker years, the opposition Liberals stressed the benefits that improved relations with the U.S. would bring and questioned the ability, and wisdom, of the Conservatives' attempts to divert trade from the U.S. One of the first initiatives undertaken by Pearson when the Liberals were returned to power was to resolve the severe problems faced by the Canadian automobile producers. At the time, more than half of Canada's trade deficit with the U.S. could be attributed to the automotive sector. Furthermore, Canadian producers were finding it increasingly difficult to compete with U.S. producers. The Bladen Royal Commission on the Automotive Sector, in its 1961 report, had proposed an integration of the North American market for automobiles and parts. The Diefenbaker government had not implemented this recommendation for various reasons, one of which was the belief that such an agreement would lead to an employment loss for Canada. However, the problems of the Canadian producers continued to worsen and Pearson decided to negotiate with the U.S., as the alternative, protectionist measures for Canadian producers, would likely lead to U.S. retaliation against Canadian exports.

The result was the Canada-U.S. Automotive Agreement which established qualified free trade in automobiles and automobile parts for manufacturers and guaranteed Canada a larger share of production.

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The negotiations began on Canadian initiative in 1964, and in a surprisingly short time, agreement was reached. The Auto Pact began in January 1965. It does not constitute a genuine free trade, as car companies can only import cars and parts duty-free as long as they meet certain conditions regarding a minimum amount of work that must be done in Canada and maintain a specified ratio between Canadian production and Canadian sales. Individuals are not allowed to import cars duty-free into Canada. The agreement has been in force ever since, with periodic reviews. There have been complaints from both sides, depending upon the balance of trade at any one time. Canada has moved into an overall surplus position in recent years, although at first it was usually in a deficit position. The major complaint on the U.S. side has been that the safeguards given to Canadian producers were meant to be transitional and should be removed. The Canadian government has insisted on the necessity of these safeguards to ensure the viability of the Canadian industry. The Auto Pact has come to represent the largest item in Canada-U.S. trade (accounting for almost 30% of Canada's exports to the U.S.) and has generally been regarded as a success.

The introduction of the Auto Pact did not cause a division between the two parties as both recognized the necessity of resolving the chronic problems faced by the Canadian automotive producers. The Bladen Commission had been sponsored by the Diefenbaker government. Furthermore, the safeguards for Canadian producers appeared to be sufficient protection for Canadian interests.

The Pearson government was an enthusiastic supporter of the GATT, which had begun the "Kennedy Round" of tariff negotiations in 1963. The Trade Expansion Act of 1962 gave that U.S. President the authority to reduce tariffs and negotiate trade agreements, and he was determined to use this authority to revive world trade. The results of the Kennedy Round were considered favourable for Canada. In the first place, Canada managed to achieve an exemption from the "across-the-board" tariff cuts of 50% which were considered the norm for bargaining. As well, Canada negotiated primarily with the Americans and received lower tariffs and improved market access for Canadian exports. The end result was that Canada was further

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integrated with the U.S. economy when the Kennedy Round agreements were fully implemented. However, as this had been achieved within a multilateral context, the result was more acceptable to the Canadian public.

Interest in free trade with the U.S. was revived in 1966 when a number of studies appeared supporting the idea, which, however, was not supported by any elected official. Both parties agreed that Canada was already too dependent upon the U.S. and the formation of a free trade area would inevitably lead to a loss of Canadian sovereignty or a political union with the U.S. As well, both parties stressed the multilateral approach to trade as being in Canada's best interests.

THE TRUDEAU YEARS: 1968-1983

A free trade arrangement between Canada and the U.S. was not part of the Liberal Party's agenda during the leadership of Pierre Trudeau. The main objective of Canada's trade policy was still multilateral and the words "sovereignty" and "independence" characterized the government's economic initiatives.

In 1972, a new era in Canada-U.S. economic relations was introduced with the publication of the "Third Option" paper. This paper was the result of an in-depth review of Canada-U.S. relations begun early in the Trudeau regime. It listed the three options facing Canada-U.S. relations: (1) Canada could seek to maintain, more or less, its present relationship with the U.S. (status quo relationship); (2) Canada could move deliberately toward closer integration with the U.S.; and (3) Canada could pursue a comprehensive long-term strategy to develop and strengthen the Canadian economy and other aspects of its national life, and in the process to reduce the present Canadian vulnerability to the U.S.(12)

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(12) These options were presented by Mitchell Sharp, Minister of External Affairs, in a special issue of International Perspectives, in the Autumn of 1972, p. 15.

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In publishing this policy paper, the Government discussed the reasons why it had chosen to pursue the Third Option of trade diversification and reduced reliance on the U.S. In rejecting the second option, the Government explained why it thought the pursuit of closer economic integration with the U.S. was not in Canada's best interests.

> A free trade area arrangement ... with the United States would, to all intents and purposes, be irreversible for Canada once embarked upon. It would, theoretically, protect us against future changes in U.S. trade policy towards the rest of the world, though not against changes in U.S. domestic economic policy. This option has been rejected in the past because it was judged to be inconsistent with Canada's desire to preserve a maximum degree of independence, not because it lacked economic sense in terms of Canadian living standards and the stability of the Canadian economy...
>
> Internationally, there is a real risk that the conclusion of a free trade arrangement between Canada and the United States would be taken as setting the seal upon the polarization of world trade. To the extent that it was, our room for bargaining with third countries would inevitably be reduced and our economic fortunes become more closely linked with those of the United States.
>
> The experience of free trade areas (such as the European Free Trade Association) suggests, in any case, that they tend to evolve toward more organic arrangements and the harmonization of internal economic policies. More specifically, they tend towards a full customs and economic union as a matter of internal logic. A Canadian-U.S. free trade area would be almost certain to do likewise. Indeed, such a course could be argued to be in the Canadian interest because, to compete, we would probably require some harmonization of social and economic costs.

The idea that free trade with the U.S. would "evolve towards a full customs and economic union as a matter of internal logic" is a concept that has always been present in discussions of Canada-U.S. free trade. The idea is accepted by both major parties. The main Conservative criticism of the "Third Option" was that, while the idea of closer

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integration of the two countries (the Second Option) was not acceptable, the Conservatives believed the search for trade diversification would damage Canada-U.S. relations without securing anything in return from either Europe or the Pacific Rim countries.

The Liberal government continued to pursue multilateral trade negotiations actively within the GATT. The Kennedy Round of multilateral trade negotiations had brought about tariff reductions that were fully implemented by 1972. Canada then entered into the Tokyo Round of negotiations which began in 1973 and was completed in 1979. The Tokyo Round was particularly significant as Canada achieved significant reductions in U.S. tariffs and improved access to the U.S. market. By the time the Tokyo Round reductions are implemented (scheduled to be completed by 1987), over 80% of Canada's exports to the U.S. will be duty-free. As well, almost 95% Of Canada's exports will be either duty-free or face tariffs of 5% or less. However, as the level of tariffs fell, the importance of non-tariff barriers to trade rose, and future multilateral trade negotiations will be concerned primarily with reducing or at least stopping the proliferation of non-tariff barriers to trade.

The idea of free trade with the U.S. was revived twice during the 1970s. In 1975, the Economic Council of Canada (ECC) released a document entitled "Looking Outward."(13) Among its major recommendations was that Canada should negotiate a free trade arrangement with the U.S. but, if this should prove unattainable, Canada would benefit from unilaterally reducing its tariffs. The ECC report attracted a great deal of comment. No politician would support these recommendations as, in the words of Jean-Luc Pépin, "free trade would lead to a customs union with the end result of political integration."

As well, the Liberal government was still seeking to give some life to the Third Option by seeking to negotiate a "contractual link" with the European Economic Community. It was envisaged that such a link would set out the conditions and terms through which Canada could diversify

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(13) Economic Council of Canada, Looking Outward: A New Trade Strategy for Canada, Ottawa, 1975.

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its trade away from the U.S. and towards Europe. The "contractual link" was finally signed in 1976, although by this time it was apparent that it would be difficult for Canada to divert a significant portion of its trade from the U.S. to the EEC.

Another impetus to the free trade discussion occurred in 1982 when the Standing Senate Committee on Foreign Affairs released the third volume(14) of its report on Canada-U.S. relations. The Senate Committee stated that the best solution for Canada's economic problems was to negotiate a free trade arrangement with the U.S. In the Committee's opinion, such a free trade arrangement would not necessarily, or inevitably, lead to a political union with the U.S. These statements were unusual in that spokesmen for both major parties had voiced the contrary opinion for many years. The recommendations of the Senate Committee did not find support within the House of Commons as the elected officials of all parties rejected these positions.

The election of the Progressive Conservatives in 1979 did not signify any changes in attitude towards free trade with the U.S. The Conservatives were determined to improve Canada-U.S. relations, which they claimed had deteriorated badly under the Liberals. However, Michael Wilson, Minister of International Trade, said the Conservatives were not willing to go any further towards free trade than had already been negotiated during the Tokyo Round of GATT negotiations (completed in 1979).

The official abandonment of the Third Option and its desired intention to reduce Canada's reliance on the U.S. occurred in August 1983 when the Minister of International Trade, Gerald Regan, released the first formal review of Canada's trade policy since 1972. Entitled Canadian Trade Policy for the 1980s, the document indicated that the Liberal government believed that Canada's interests might be best served by closer relations with the U.S. According to the document: "Many of the arguments favouring freer trade may be satisfied, however, by entering gradually into bilateral agreements to resolve particular issues. Free trade with the U.S. on such

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(14) Standing Senate Committee on Foreign Affairs, Canada-U.S. Relations, Vol. 3, Canada's Trade Relations with the United States, Ottawa, 1982.

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a limited, sectoral basis would not raise the more difficult issues posed by the full free trade option and would be consistent with the gradual movement by successive Canadian governments towards free trade."(15)

The argument that more trade with the U.S. may lead to political dependence, the basis of the selection of the Third Option as a trade policy objective in 1972, is repeated: "Many Canadians, including a number of those who would accept the validity of the economic case for free trade, would reject a Canada-U.S. free trade agreement on the grounds that the process of managing the North American economy would lead inevitably to the formation of common institutions; given relative economic weight, the U.S. would tend to dominate these institutions; and Canada's political sovereignty would, over time, be eroded."(16) However, the arguments of the proponents of free trade between the two countries are also presented in such a way that their arguments are not dismissed either easily or readily.

Following the release of the trade policy review, the Canadian and U.S. governments undertook a series of meetings concerning the possibility of entering into sectoral free trade in four areas: mass transportation equipment; informatics (i.e., computer services); steel; and agricultural equipment. As well, several other areas have been mentioned as possibilities for future discussions - textiles and clothing; petrochemicals; and marine equipment. As yet, the discussions have not led to the signing of any agreements.

The present Conservative government has continued the discussions initiated by the Liberals in 1983.

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(15) Department of External Affairs, Canadian Trade Policy for the 1980s, August 1983, p. 45.

(16) Ibid., p. 43-44.